DOW THEORY LETTERS INC.

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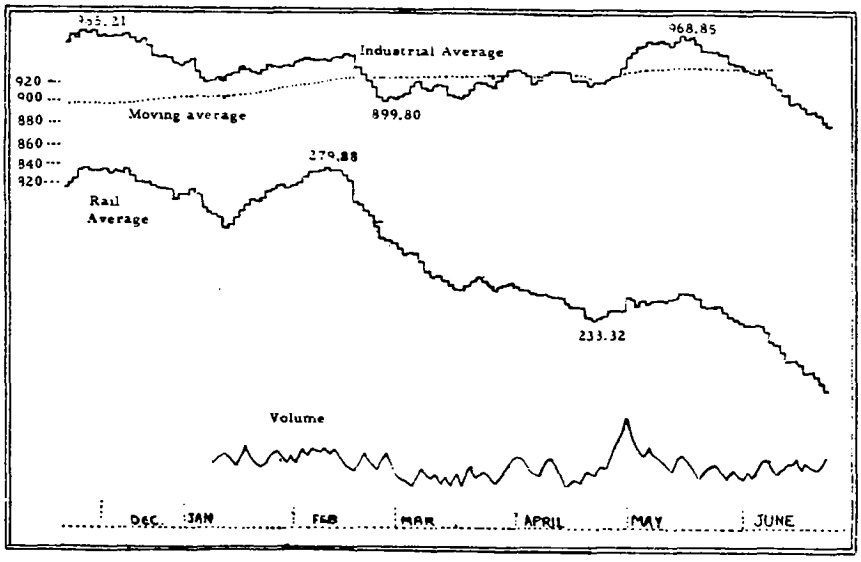
THE MARKET: As this is written (June 23) the Dow is down below the 870 level. "Oversold" (as predicted in the last Letter) is now the most popular word on Wall Street, and I have no quarrel with that word. True, by all recent standards the market is oversold, but I have just rechecked some past market oversolds, and they make the word meaningless in a primary bear market.

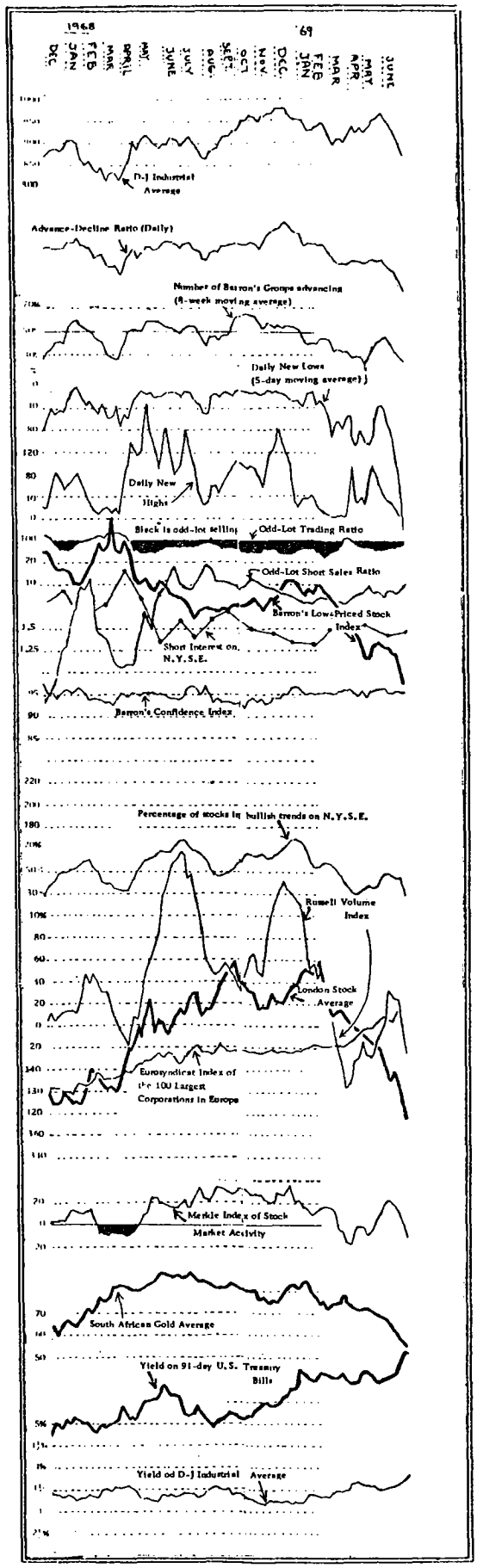
For instance, the Advance-Decline Ratio (A-D) has just dropped five points in a straight line, which is admittedly very drastic downside action, action rarely seen. But during March to May, 1931, the A-D ratio dropped 14 points before rallying. After the (one-month) rally, the A-D ratio during July to October, 1931, dropped an additional 13 points. Another rally occurred and the A-D ratio plunged 10 additional points during November-December, 1931. Oversold, the Exchange had never seen anything like it! Between August and November, 1937, the A-D ratio dropped 15 points, producing another massive oversold. So I'm not denying that the current 5 point drop in the A-D ratio isn't a big one — but they can get bigger, much bigger (and all the while the market is oversold.

Meanwhile, Bill Gordon writes that the short interest ratio on the 30 Dow Industrials was .70 for May-June. This means that the Dow short interest ratio has held under the critical 1.0 level for 17 out of the last 18 months, a display of weakness unmatched in the history of this indicator.

Odd-lot statistics have been anything but bullish, showing a swing to the buy side as this market descends. Just as discouraging has been the extraordinary lack of odd-lot shorts. For instance, Garfield Drew's Odd-lot short sale index touched 91.4 on October 13, 1966 during that decline. The latest figure provided by Drew shows this Index at an incredibly low 11.7, recorded June 19, 1969. Odd-lot shorts have literally refused to short this decline. I would guess that Drew's index would be in the 50 to 100 range before the slide is over.

All in all, the whole mess proves the wisdom of staying out of all rallies and declines in a primary bear market. The occasional profitable scalping




1968
69
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Groups advancing (9-week moving average)
Daily New Lows (5-day moving average)
Daily New Highs
Block is odd-lot selling
Odd-Lot Trading Ratio
Odd-Lot Short Sales Ratio
Barron's Low-Priced Stock Index
Short Interest on N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on N.Y.S.E.
Russell Volume Index
London Stock Average
Eurosyndical Index of the 100 Largest Corporations in Europe
Merkle Index of Stock Market Activity
South African Gold Average
Yield on 91-day U.S. Treasury Bills
Yield od D-J Industrial Average

 operations on the upside aren't worth the risk of getting caught in a bear market collapse. But that's something which newer investors may have to find out the hard way. I'm not worried about my older and veteran subscribers. They've had their "Baptism of Fire" before, and they know the meaning of the phrase, primary bear market.

MARGINS: Currently, there is $5.6 billion outstanding in margin accounts on the New York Stock Exchange. Interest charges on margin accounts run from roughly 9.25% to above 10%, depending upon the size of the account. The average stock on the N.Y.S.E. now yields 3.17%, as gauged by the yield on the Standard & Poor 500 Stock Average. Figuring a return of 3% on stock (via dividends) against a margin rate of 10%, it is costing the average buyer something like 7% a year to carry his margin.

It is one thing buying high yielding stocks during periods of low interest rates; it is another thing holding low yielding stocks at a time when margin rates are at fantastic highs. Those who purchased General Motors, General Electric and DuPont on margin during the early 1950's had an excellent case for saying they had "margined investments." The fact is they did, and if they held onto those margined investments they did very well indeed. But those who own stocks yielding 3% on average during a period when it costs them 7% (after dividends) to hold those shares are in an entirely different position.

Every man who holds stocks on margin today during this bear market at a time when it cost him roughly 7% a year to carry those shares, every such individual is a speculator pure and clear. He has a bet that this market will bail him out of his predicament. What is his predicament? It is this: If his stock stands still for a year he will lose 7% of his capital, in two years he will lose 14%, in three years 21%. This is a definite psychological pressure. Worse still, if his stock goes down his loss is compounded, and the psychological pressure to "get out" becomes intense.

This type of speculator cannot sit calmly and hope that the market goes up. He is sweating and praying that the market will go up. Rationally, no man should be on margin at a time when low stock yields and high margins cost him 7% a year on his speculation. The arithmetic should tell him that it is not a choice gamble, much less a speculation. Historically, when a man pays 7% for the privilege of speculating the percentages are telling him that he should not be in the market.

My guess is that before this primary bear market is over, a large percentage of today's margined speculators are going to be squeezed out with massive losses. In fact, it would not surprise me to see 80 to 90% of the current $5.6 billion in margin accounts squeezed out before the bear market ends in exhaustion. In the meantime, losses in general should continue to mount and margin holders should become increasingly discouraged.

In his latest report, economist Eliot Janeway notes that during the 1966 "credit crunch" the big banks were low on funds but the secondary sources did have funds. The rates for cash from the secondaries ran around 18% in 1966. Today, says Janeway, the rates are a hypothetical 25%, which indicates too much risk for comfort. "In past panics big enough to rank as historic milestones," writes Janeway, "the point has been reached at which rate will not bring out money. Credit has now dried up at any price."

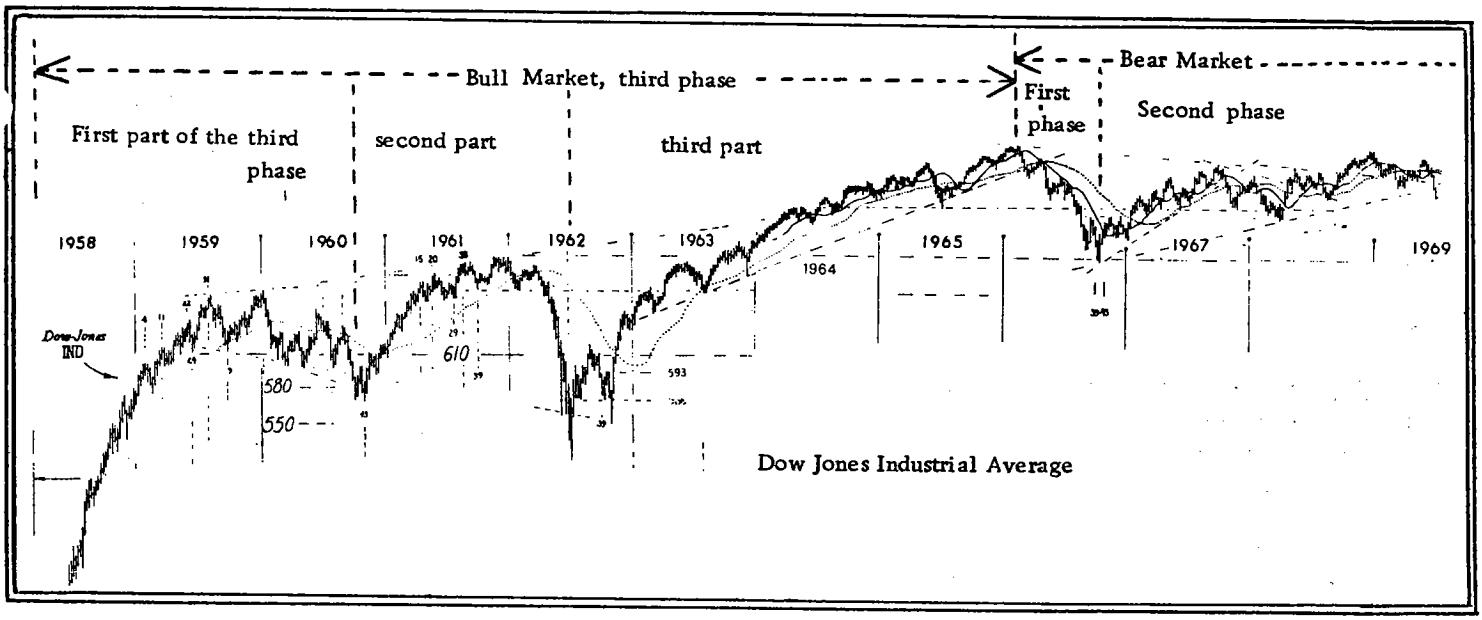
Janeway believes that relief will come when the panic-trouble comes, and that sounds reasonable to me. At least I believe that the Federal Reserve Board will probably attempt to reverse the gears if panic arrives, but I am not convinced (1) that the Fed will be able to undue the damage, or that (2) panic psychology will turn bullish even after rates ease up.

WHERE ARE WE? The chart on page 3 (courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kans.) has been divided off to show my interpretation of where we are in this stock market.

The great bull market which began in 1949 entered its first psychological phase in 1949, and this phase lasted until 1953. That first phase represented the initial upward push from the depressed level of the early-1940's. The second phase began in 1953 and lasted to 1957. That was the phase wherein business was obviously improving, and the professional and a bit of the public moved in and took their positions. The third phase of the bull market (which is pictured on the chart) was extraordinary in that it was divided into three parts.

This massive, extended third phase of the bull market represented one of the most deceptive periods in American finance. Actually, the bull market probably "should have" terminated in 1959, but huge infusions of bank credit kept the boom alive, pushing it further and further into the stratosphere. By February, 1966, the Industrial Average had finally discounted the best that could be seen ahead. The senior average was exhausted, and no subsequent "priming" by the Federal Reserve Board, no pushing by political or business leaders could move the Industrials over their 1966 bull market peak.

The first phase of the primary bear market which began in February, 1966, was deceptively short and mild. It terminated at the October, 1966 low of 744.32 for Industrials. From the 1966 lows, the Industrial Average surged up again, but this time nothing the Reserve Board, nothing the continuing white-hot business boom, nothing galloping inflation could do would take the Industrial Average over the 995.15 1966 high.



The attacks on the 1966 Industrial high have again constituted a group of three. The first surge terminated at the 1967 high of 943.08. The second attack ended at the 1968 peak of 985.21. The third push ended in 1969 at 968.85. As I interpret it, these three attempts since 1966 to better the 995.15 high are all part of the second phase of the bear market. The second phase of a bear market is usually the longest phase, and this current second phase has already lasted a little less than three years. The greatest part of the second phase, so far, has been an upward move from the 1966 lows. During this period billions of dollars worth of stock has been distributed, much of it into the hands of the funds and the public.

Classically, the second phase of a bear market is the phase in which the market reflects deteriorating business conditions. Although the background for business has deteriorated and conditions increasingly hint of danger, business itself has not fallen apart.

The 1969 peak for the Dow was 968.85. No one knows for certain whether the decline which began in May, 1969, is the beginning of the end for the second phase or not. For the completion of the second phase, I would expect the following two conditions to occur: (1) I would expect the Averages to extend their decline through the 1966 lows, and (2) I would expect business conditions and corporate earnings to turn undeniably poor.

Following the end of the second phase we might expect another upward correction with perhaps some lessening of business tensions. Then we would look for the final or third phase of the bear market. This could be accompanied by scary news events, depressing business conditions, large-scale unemployment, collapsing corporate earnings and a sick, relentless retreat by the Averages to lows perhaps far below anything envisioned even by the bears today.

At any rate, this is one possible blueprint for the stock market over the several years ahead, and it is the one I personally expect to develop. At the final bottom, those investors who are in a safe, sheltered position will probably have a chance to reinvest at prices which could represent the highest bargains available during the next two or three decades (or in any of our lifetimes). So there it is, no one has to accept it, no one has to believe it, but I present it for your study. I think it's going to happen.

INFLATION AND ALL THAT: I have written about the dangers of inflation until I'm tired of the very word "inflation." Suffice it to say that so far, despite the tightest money rates since the Civil War, inflationary signs continue. Prices are still rising (although not on Wall Street), labor contract terms are outlandish, costs of services are pushing up, wholesale prices are moving higher. In the face of this discouraging picture, the Federal Reserve Board keeps trying to hold the clamps on the money situation. But it isn't all that easy.

For instance, in the single week ending June 11 U.S. commercial banks borrowed a record $1 billion Eurodollars from their foreign branches. But even the Eurodollar market (with interest rates running from 10 to 13%) is now drying up. Other non-Fed sources such as commercial paper and bankers' acceptances are either giving out or bringing record interest rates. The money well is finally running dry.

In the debt markets many bond issues are being voted down by the citizens; other issues are being withdrawn by state Treasurers due to market conditions which have driven interest rates above ceilings specified by state law. The Government is making sundry attempts to cut back on spending, and the consumer seems to be losing a bit of his spending passion. Business, nevertheless, expects to spend $72 billion in 1969 on plant expansion—that is, assuming they can finance their grandiose plans. The crux of it is that most people still persist in their belief that inflation is a way of life. Nothing short of a disaster is likely to change their view.

Only Wall Street seems to be taking the inflation fight seriously. And this is as it should be, because Wall Street has a way of protecting itself long before the rest of the nation is even aware of what is happening. The stock market has been deflating itself ever since the May 14 highs, and it could be three to six months before we find out what Wall Street is really saying. My own guess is that the stock market is discounting deflation, a sag in corporate earnings and a host of other troubles as yet unnamed. I do not advise readers to hold to the line that "the market is just nervous and doesn't like uncertainty." When the breadth index (see next section) breaks below a 16-year low, the market is more than just nervous.

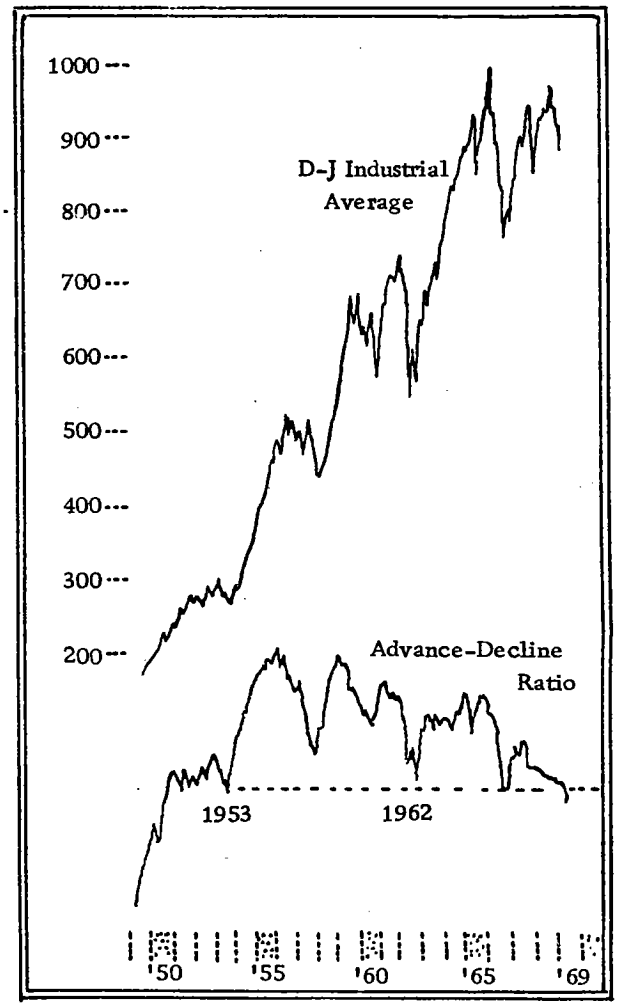
A LONG LOOK: I love good charts, particularly long-term charts. They cut through all the nonsense, the explanations, the fantasies and the misconceptions. They show you where you've been, where you are, and they offer hints as to where you're going.

For instance, how many investors do you know who can tell you what the current June decline did in terms of the advance-decline ratio? Probably not one in 500. Yet I consider the current position of the Dow Industrials and the A-D ratio to be of utmost importance.

I include the accompanying long-term chart of the Dow and A-D ratio covering the period from 1949 to the present. It's a bit of a shocker. Note that the A-D ratio established its extreme high during 1956. A second peak in 1959 almost approximated the 1956 peak. The 1962 market cave-in took the A-D ratio almost back to its 1953 bottom; nevertheless, the 1953 bottom did hold during 1962.

In 1966 the October bear market low brought the A-D ratio back below the 1962 low, but still above the 1953 low. At this point it could be said that the A-D ratio was acting poorly but nevertheless consistently holding above a long-term bottom extending back to 1953.

From the standpoint of breadth, it is undoubtedly significant that following 1959 each peak on the A-D ratio was substantially below the last peak, as noted on the chart the peaks of 1961, 1965, 1966, 1967 and 1968. Whenever the A-D ratio moves sideways or refuses to record new highs the general implication is that the market is selective with roughly as many stocks moving up as down over a long period of time.



Now we come to the 1969 development. During the latest decline the A-D ratio broke below all bottoms going back to 1951. Thus the A-D ratio is now in the area of its 1949-1951 advance. During the 1949-51 rise the Dow Industrials rallied from 161.61 to 276.37. With the A-D ratio back in the area in which the Dow was roughly 600 points below its current level, it gives one food for thought. What if the Industrials were to begin to fill the fantastic "vacuum" created by the collapse in the A-D ratio? If this were to happen, the market could be subject to a smash of absolutely historic proportions.

No one has any right to predict an event as rare as a major stock market crash. Since a crash occurs perhaps once in a generation, the odds against such an event are always huge. But it does seem to me that the technical underpinnings of this market are about as out-of-kilter as they ever get. The A-D ratio collapse has created a vacuum of proportions not seen in forty years. During 1929, with the Industrial Average near its all-time high, the A-D ratio plunged below its 1921 low. This set up the vacuum which allowed for the 1929 crash. By the same token, here in 1969, with the Industrial Average only 100 points under its 1966 peak, the A-D ratio has dropped under the 1953 low, a low which was recorded 16 years ago. Technically, the price-breadth relationship in 1969 is comparable to that of 1929.

Secondly, the Dow Industrial short-interest ratio is now more bearish than at any time since 1931 (our records of this indicator begin in 1931). The Dow Short Interest ratio (see Letter 429) has held under the critical 1.0 level for 16 out of the past 17 months, and this would suggest that the technical underpinnings of the Dow are extremely weak. If the Dow were to attempt to catch up to the A-D ratio on the downside, the Dow short interest ratio would offer little encouragement as far as potential resistance to the decline.

GOLD, POLITICS AND ALL: William Martin, Chairman of the Federal Reserve Board, finally laid it on the line in Copenhagen at a meeting of 300 bankers from around the world. Martin stated that inflation in the U.S. would be stopped, and any measures necessary would be used including voluntary credit controls, "forced savings," and a higher surtax. Said Martin, "We're going to have a good deal of pain and suffering before we can solve these things." He added, "I'm not here to predict collapse and decline. There's no reason to have collapse and decline. But if we throw these principles to the wind, there is no gadgetry in monetary mechanisms and no device that will save us from our sins."

This time the Fed does not appear to be kidding themselves or the public. The Fed appears ready to accept real trouble rather than allow inflation to continue. To me, it's all rather ironic. If the same resolve were used in 1959 or even 1961 perhaps the trouble could have been held to a minimum. The irony is that the Fed waited until the whole monetary and economic system had grown into an inflated monster before getting down to the serious business of monster-killing.

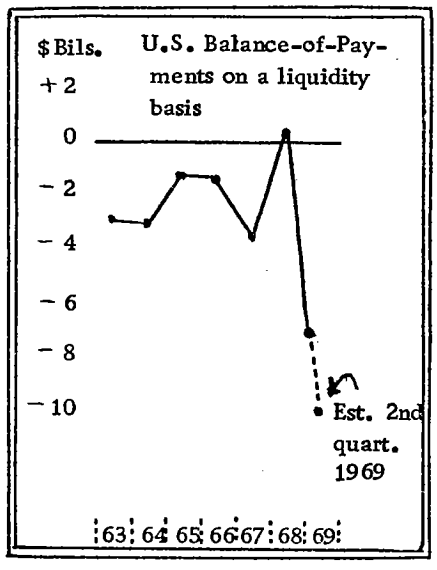
I think the Fed and the previous Administrations allowed their cowardice to continue far too long. It's now a problem of what happens when the monster topples over and dies. The monster isn't ten feet high any more, he's a mile high, and when he falls he's going to make a sound heard around the world.

The bear market which is on the way (in my opinion) is going to be far more drastic than Mr. Martin, Mr. Nixon or anyone else envisions. I don't think the bear market is going to respond bullishly to a reversal of policy when that reversal is deemed necessary. I believe it is going to be a case of out-of-control deflation much as it is now a case of out-of-control inflation.

When I recommended our hedge position of 10% to 15% in gold shares, I did not foresee or could not guess exactly how events would work out. Now we are nearer the big picture, and now I will hazard a guess. I would guess that the whole deflation process (aided by the primary bear trend) is going to scare the politicians to death, that priming the pump again is going to fail, and that as rampant deflation and collapse spread across the world, the various governments are going to raise the price of gold (perhaps triple it) in an effort to turn the tide to the upside.

Instead of raising the gold price a few years ago while putting the clamps on inflation, Washington has held the gold price while allowing inflation to sweep the country. Events are now taking over where politicians have feared to tread. To holders of gold, therefore, I would say, hang on, the gold price will ultimately be raised, but it will be raised in the face of economic collapse as a measure to stem the tide of the bear.

BALANCE-OF-PAYMENTS: The Balance-of-payments figure which the market men watch is the U.S. Balance-of-Payments on a liquidity basis. This is the change in all official reserve assets and change in liquid liabilities to all foreigners. This B.O.P on a liquidity basis is also the figure foreigners watch. It shows the real liquid position of the U.S., and the real position of the dollar.

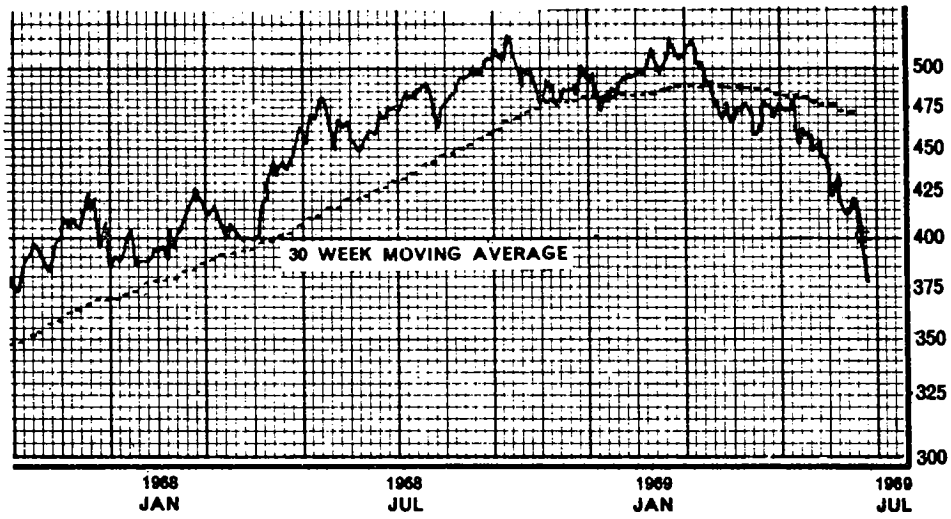


I have charted the B.O.P on a liquidity basis (figured on an annual basis), so that we will now look at the U.S. the way foreigners with dollars look at us. It is not a pretty sight, the shocker may be coming up in the second quarter.

A slight surplus was recorded during 1968 of $190 million. This surplus developed due to three special factors. (1) U.S. Corporations pulled out funds from overseas subsidiaries because those funds were needed here. (2) Special placement of non-negotiable securities (mainly in Canada and West Germany) which were of long enough maturity to qualify them as foreign investments in the U.S. (3) Huge foreign purchases of U.S. securities, which added heavily to the U.S. liquidity figures.

It is of interest that during the first and second quarters of 1969 all three of these special categories have been reversed. But worst of all, the traditional U.S.

excess of exports over imports has now turned into a negative factor. For instance, before 1967 the U.S. enjoyed a positive export-import surplus of better than $4 billion a year. Last year the surplus dropped to $100 million. During the first quarter of 1969 (partly due to the dock strike) imports exceeded exports on an annual basis by $1.2 billion.



All in all, the U.S. balance of payments in 1969 looks worse than ever before, and if the stock market continues to decline (as foreigners sell their U.S. stock and pull out the money) it will look still worse.

What does all this mean? It could be shaping up as a case of troubles breeding more troubles. A disastrous B.O.P. account would only make foreigners still more doubtful about keeping dollars and investments in the U.S. The first quarter, 1969 B.O.P. figure on a liquidity basis (see chart) shows a drop to $7.1 billion on an annualized basis. What worries U.S. men-in-the-know is that there is a very real chance that the second quarter, 1969, figures (dotted line on chart) are going to show a B.O.P. drop to $10 billion on an annualized basis.

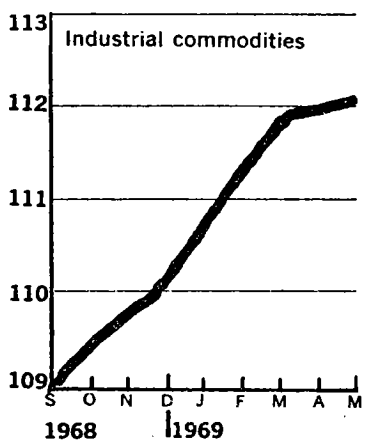
If this does occur, confidence in the dollar will be seriously undermined, and drastic steps can be expected in an attempt to cut the out-flow of dollars from this country. This is one of the "unspoken" reasons behind the Fed's current tight money policy.

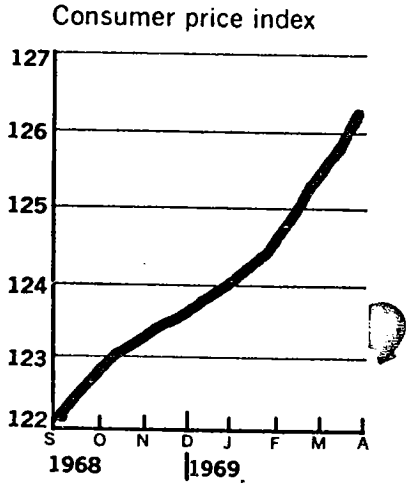
It has been the worst bear market since the war. Since the high days of January, when the Financial Times Ordinary share index reached 521 and the merger boom and market rise fed off each other, the fall in prices has been punctuated by repeated pauses at support levels which have done little more than allow the pessimists to jettison their stock. At 391 on Wednesday and having fallen 20 points since Tuesday, the bears were really out. "In all my experience," said one investment manager, "I've never seen a market like this, with stocks being sold for no apparent commercial reason." He was not entirely alone; on Thursday the market was back around 400.

BRITAIN: Inflation and deflation in Britain are clashing head-on. The British bank rate is now 8%, but it should be higher. At 8%, British interest rates are not higher than American interest rates, and since the pound is weaker than the dollar British rates should very obviously be higher than U.S. rates.

Britain is now in a mini-recession. The British stock market is being rocked on its heels. They have suffered a drop equal to a plunge which would take the Dow to around 650. And all this since January! I include this clip from the June 24 London Economist together with a chart of the financial times stock Average. Inflation has been a talking point for buying stocks over the past few years in London. It isn't a good talking point any more.(Chart courtesy of The Investor, 354 Kennington Rd., London).

CHARTS OF THE WEEK: The problem is that so far, the monetary squeeze isn't doing the job. If the Fed is serious, it isn't going to relax its efforts until these two charts are moving down. This could take a few months or six months or even longer. Every day now analysts are quoted as saying that the market is a "buy", because as soon as inflation falters, the Fed is going to ease up and the market is going to zoom as interest rates head down. That's the bull case, and it's simple and pat. I don't think it's going to be as easy as all that, and I wonder whether it won't take a market collapse to actually turn the figures around.





LATE NOTES: On June 23 (Monday) all three stock averages, the D-J Averages, the A-D ratio and the 40-Bond Average plunged to new 1969 lows. On June 25 the market rallied with the Industrials up 7 points at the opening. It's about time.